

Credit Opinion: Veolia Environnement S.A.

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Paris, France

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3
Sr Unsec Bank Credit Facility -Dom Curr	A3
Senior Unsecured	A3
Commercial Paper -Dom Curr	P-2
Three Valleys Water Plc	
Outlook	Stable
Issuer Rating	A3
Three Valleys Water Finance Plc	
Outlook	Stable
Bkd Senior Unsecured -Dom Curr	A3
Tyseley Finance PLC	
Outlook	Stable
Bkd Senior Secured -Dom Curr	Aa3

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Key Indicators

Veolia Environnement S.A.

	2007	2006	2005	2004
EBIT Margin	8.7%	8.2%	8.4%	7.6%
EBIT/Interest Expense	2.4x	2.4x	2.3x	1.8x
FFO Interest Coverage	4.2x	4.7x	4.3x	4.0x
FFO/Net Debt	19.6%	19.5%	18.0%	18.3%
RCF/Net Debt	16.6%	16.9%	15.8%	15.8%
RCF/Capex+ Acquisitions (net of divestitures)	97%	115%	105%	105%

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Company Profile

Headquartered in Paris, France, Veolia Environnement SA ("Veolia/the company", rated A3/Prime-2, stable outlook) is a leading provider of outsourced services for the urban environment, with a presence in more than 65 countries worldwide. The company operates through four divisions, grouped around intermediary holding companies, namely: Veolia Water (formerly Compagnie Générale des Eaux), the company's water and waste water division; Veolia Environmental Services, the waste division; Veolia Energy, which provides energy services; and Veolia Transportation, the smallest of the four. The four divisions are linked by a strategic vision to provide services for the urban environment to a common customer base, mainly public authorities (which account for approximately 70% of turnover) and industrial customers (30%) which provides scope for revenue and cost synergies. Water and Environmental Services, which together accounted for almost 64% of EUR 26.3 billion revenues in the first nine months of 2008, are the more profitable divisions reflecting their scale and leadership

position worldwide.

Rating Rationale

ASSESSMENT OF BUSINESS RISK FACTORS

Veolia's A3 rating is based on a relatively low business risk profile, which factors in that the majority of its operations are in the relatively stable water and waste industries, both of which benefit from positive underlying structural growth dynamics. It also takes account of: (i) the stable and predictable cash flows generated from Veolia's large portfolio of long term contracts and customer relationships (its Water business worldwide comprises some 5,000 agreements); (ii) the generally good credit profiles of its municipal and industrial counterparties; (iii) the company's diversity, which limits its reliance on any specific geographic market or activity, and (iv) its leading market positions, particularly in water, where Veolia is the world's largest supplier of water, waste water and environmental services.

Both water and waste industries benefit from positive long-term underlying structural trends. Population growth, the ongoing trend to urbanisation and industrialisation, and an expectation of rising living standards combine to exert pressure on water distribution and waste management infrastructure in most countries. Together with public and regulatory concern at the impact of climate change on scarce resources this is combining (i) to increase demand for existing technologies for the provision of water, waste water and waste management services; and (ii) to extend demand into new service areas and technologies. More cautiously, the rating also factors in the Group's presence in the Energy Services and Transportation sectors where profitability has been more pressured.

Veolia's business model and long term stability are dependent on its ability to renew contracts as they approach the end of their term. Given the company's contract driven approach and the lack of "owned" assets and activities, the average contract term is a key factor underpinning Veolia's credit quality. Moody's notes that Veolia has a good record of renewing its contracts at expiry achieving, for example, a renewal rate of 95% in the local authority water sector in France, and that it has successfully managed to balance longer term capital oriented contracts with shorter term operating contracts, and broadly maintain the average contract term.

ASSESSMENT OF FINANCIAL RISK FACTORS

Veolia's financial risk profile is underpinned by the cash flows generated by its operating businesses. These cash flows are generally stable and predictable, accruing from multi-year contracts involving essential and critical services with low credit risk counterparties. The company's portfolio of thousands of contracts across its four divisions and the diversity of such by sector and by geographic spread also provides good credit support to its cash flows, as does its record of contract retentions and their average remaining life.

The A3 rating factors in that the Group's recurring operating margin has come under pressure in recent periods. Having softened slightly from 7.8% in 2006 to 7.6% in 2007, the outlook is for a further decline in 2008 given the 6.7% reported at Q3 2008, down from 7.5% in Q3 2007. The three larger divisions have each experienced margin weakness, even if turnover growth has been strong. This has in part reflected the dilutive impact of certain recent acquisitions in the Waste division, and the rising contribution of lower margin and less capital intensive engineering works businesses in the Water division. In addition, the company recently indicated that the waste business had experienced a slowdown in activity during 2H2008. Together with the effects of the economic slowdown and the decrease in raw material pricing, especially in France and Germany, Veolia expects 2008 operating cash flow to be between EUR4.1 billion and EUR4.2 billion, broadly in line with EUR 4,163 million generated in 2007.

With the outlook for operating margins to remain under pressure in the shorter-term Veolia has flagged its intent to prioritise a recovery in ROCE after tax to more than 10% by the end of 2010, from an expected 9%-9.5% in 2008. To that end, and in addition to continuing its efforts to grow turnover, Veolia has indicated a number of measures including: (i) a cost reduction plan targeting EUR 400 million in savings over 2 years, of which EUR 180 million in cost savings is expected in 2009; (ii) the disposal of underperforming assets, with EUR 1.5 billion disposals by end-2009, of which EUR 1 billion to be achieved or committed in 2008; and (iii) a moderated investment plan with capital expenditure in the range of EUR 5.0 billion and EUR 4.5 billion expected for 2008 and 2009 respectively (versus the EUR 6.9 billion in 2007).

Net financial debt increased during the first nine months of 2008 to EUR 16.7 billion and is likely to rise further on the back of capital expenditure and pressured operating margins. As a result Veolia's leverage is likely to rise towards the upper end of its Debt Ratio Target range of between 3.5x-4.0x, over the period 2008-2009, from the 3.4x reported at June 2008.

Given rising borrowing and flat operating cashflow generation there is a risk, in Moody's view, that the Group's credit metrics for 2008 weaken towards the low end of guidance for the A3 rating - including retained cash flow/net debt in the range of 14% to 18% - and potentially slightly below. In that context, while noting current more depressed asset valuations, Moody's assumes that Veolia's moderated rate of capital investment and planned asset disposals should enable the Group to reduce leverage such as to position it more comfortably within its target range within the shorter-term.

Liquidity

With EUR 2.1 billion in cash, cash equivalents and marketable securities at October 2008, Veolia's liquidity profile is solid. The company has access to a EUR 4.0 billion syndicated facility maturing in 2012, of which EUR 1.150 billion were drawn in October, and to undrawn bilateral facilities of EUR 1.025 billion. These facilities contain no triggers, covenants, MAC or general restrictions. Veolia also has a EUR 4.0 billion Commercial Paper Programme in place, of which EUR 285 million was outstanding at June 2008. The group accesses the CP market on a daily basis and aims to cover a high proportion of its short term debt, including CP outstanding at any given time, by its undrawn committed bank lines and cash. Peak CP usage is not expected to exceed EUR 2.0 billion at any point during the next 12 months. The company also has a EUR 12.0 billion Euro Medium Term Programme in place, of which EUR 9.1 billion was outstanding as at June 2008.

Rating Outlook

The stable rating outlook assumes that Veolia's efforts to focus on ROCE, contain capital expenditure and asset disposals will underpin profitability and help maintain leverage in line with its targeted capital structure.

What Could Change the Rating - Up

Although unlikely in the short-term given current margin pressures, an upgrade could follow a material strengthening of Veolia's financial profile as a result of improved cash generation and/or significant disposals and/or lower net adjusted debt, such that RCF/debt were to rise above 18%.

What Could Change the Rating - Down

Negative rating pressure would likely develop in the event of a deterioration in financial profile - as would be evidenced by RCF/debt declining sustainably below 14%, whether as a result of lower than expected profitability and cash flow generation, or extended delays in achieving any asset disposals planned in the context of achieving the Group's Debt Ratio Target.

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